

# FREE TRADE IN EURASIA? OR IS HOME WHERE THE HEART IS?

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## Abstract

Free trade benefits us all and is firmly guarded by the WTO. In earlier research we showed that complaining at the WTO is not always induced by objective facts. We argue that if this is actually the case, trade is not sustainable as it should be, but disruptive instead. It implies that sub optimality is introduced, distorting the beneficial effect of free trade known as in the theory of comparative advantage. In this paper we look at the complaining behaviour on the Eurasian continent and we try to distil driving forces. We are particularly interested in the role of the European community, one of the major complainants. Can we explain this behaviour in terms of home bias, as we found for several other nations, or is this complaining related to objective facts which are subject of international treaty's such as airplane safety? In our earlier exploratory research we worked on data of 28 countries which we analysed using correlation and stepwise regression, finding interesting results. We actually distilled a trend involving home bias. We again pose the question if Eurasian complaining is actually about for instance airplane safety or do also Eurasian countries use treaty's like this to steer away from competition? Is this leading to disruptive trade or the opposite, making trade more free and sustainable? We use statistical analysis and report on a number of incidents, and eventually focus on the role of Foreign Direct Investment in the subset of 28 countries versus Eurasia. We explain why results between the subsets differ to a considerable extent and show convincing examples of home bias induced policy.

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**Keywords:** Trade barriers, WTO complaints, economic structure, home bias

## Introduction

The current literature still needs to explore the relationship between the number of complaints filed at the World Trade Organization, WTO and the economic structure of the WTO members at the macro level. This paper explores the phenomena of the trade complaints and factors which induce and motivate to file complaints. The purpose is to gain an insight into the factors which are correlated with the complaining behaviour of the WTO member countries, Eurasian countries in particular.

The WTO, with the 159 members and 25 observers champions the cause of an open economy with trade liberalization policy. The WTO also facilitates the necessary organizational infrastructure for the members who are perceived as not being kept to the treaties. The WTO is an international institution championing free trade. WTO states as one of the objectives: "Lowering trade barriers is one of the most obvious ways of encouraging trade; these barriers include customs duties (or tariffs) and measures such as import bans or quotas that restrict quantities selectively." Discouraging 'unfair' practices, such as export subsidies and dumping products at below cost to gain market share is a complex issue. The rules trying to establish what is fair or unfair are very difficult.

### **China – EU: Solar Panels**

European solar panel manufacturers have escalated their legal campaign against Chinese rivals by filing a fresh trade complaint in Brussels accusing them of receiving illegal government subsidies.



The anti-subsidy complaint comes just weeks after the European Commission, the EU's executive arm, roiled trade relations with Beijing by opening a separate anti-dumping investigation against the Chinese companies (Reuters, 2013).

*Box 1: The case on Solar Panels is a justified complaint at the WTO because the Chinese heavily subsidise the production, making trading solar panels dumping in legal terms. In this case an agreement can do what it is supposed to do: ensure and regulate free trade.*

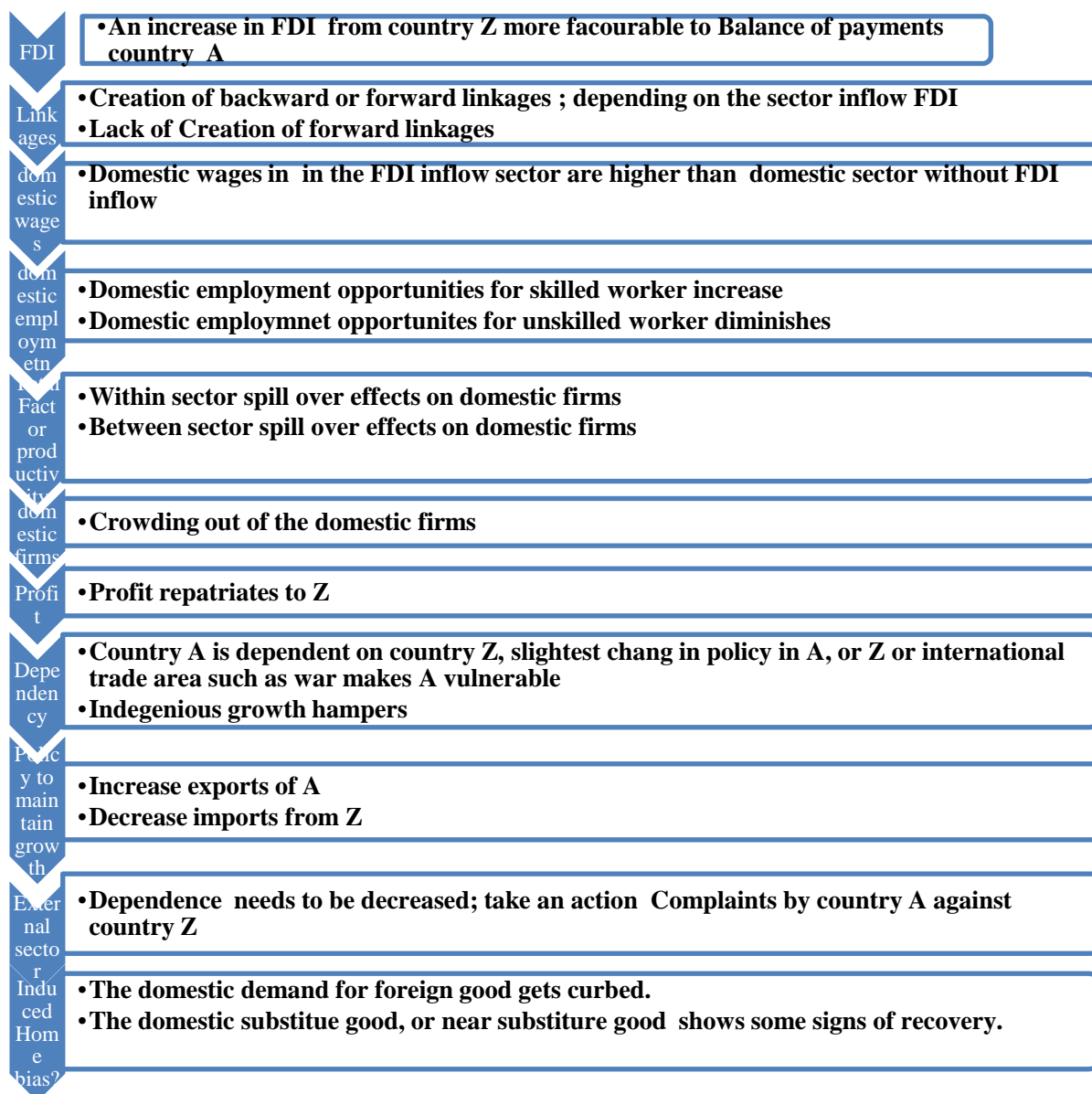
A country WTO member may decide to complain against a particular country when it perceives trade barriers. These trade barriers, which are most probably against a certain treaty.

Alternatively, it might also be a suspicion, when a country suspects an element of barrier against a treaty. It defines a WTO complaint, justified or otherwise, as a legal measure with strong national political backing and hidden economic motives. It is not possible to capture the hidden economic motives directly. It may be a sign of induced home bias. The action of lodging a complaint may be an unintentional or even an intentional induced home bias action. Based on the outcomes of the analysis of a subset of 28 countries, an odd set with relatively many South American countries and also a big economy like India versus Eurasia and we present three cases. We draw some tentative conclusions.

### **Literature and theory overview**

An open economy implies openness to the foreign trade, export and import activities. The export results in the inflow of money and imports cause outflow of money. Rationally each country wants to maintain or maximize its potential of its share in export and balance it with import if not reduce imports. The economic circular flow for an open economy consists of five sectors; namely the household sector, the firm sector, the financial sector, the government and the external sector. It is assumed that the countries, which have joined WTO have been actively busy with the opening of the economy, making free trade free as much as possible.

Diagram1: Chain of reasoning on complaints induced by home bias, a theoretical reasoning on FDI (Foreign Direct Investment)



Households own the assets of the economy and distribute their incomes to consume and save. Exchange of goods takes place in perfectly competitive markets when it comes to international trade. The firm sector sells their products to household and to firms in the external sector. The household sell their labour and assets to the production sector. The available factors are utilized to the optimum level. The saving is made by the household sector to the bank, which is distributed by the bank to the firm sector. Furthermore, the countries have realized that import substitution is less optimal for the growth process than an export promotion strategy for growth. Being a part of the globalizing world and as WTO member, it is imperative to lessen trade barriers.

### China – EU textile crises 2005

Chinese clothes exports to EU 5 September 2005 Millions of textile and clothing goods from China are being held in European warehouses, because of a dispute over import quotas Chinese-made bras, blouses and T-shirts are piling up at customs checkpoints across Europe, having already bumped up against import limits set earlier this year. A team of officials from the European Union has been in Beijing trying to negotiate a way out of the crisis, so far to no avail. But European retailers are just as annoyed at the quotas as the Chinese....



This showdown has been brewing for a while. When China became a member of the WTO in 2001, it did so under special terms that allowed importing countries to impose short-term “safeguards” on Chinese goods until 2013 if they could show those goods to be causing “material injury” to domestic producers. And separate measures for textiles allow safeguards to be imposed whenever imports threaten “market disruption”. The expiry of the previous quota system made it inevitable that countries with big textile industries—such as France, Spain and Italy—would press for quotas to be imposed. **At best, the quotas are only delaying the inevitable.**

*Box 2: The Textile crises of 2005 is a clear example of home bias induced policy. Due to comparative advantages the production of textiles is shifting to the East. The production of these textiles is not subsidised, but is just very much cheaper to produce textiles in Asia in 2013 due to low labour costs.*

The government sector has to fulfil the wishes of not only the household sector, which is a supplier of labour but is also expected to be able to facilitate the firm sector. The firm sector should be able to produce the goods at competitive prices. Furthermore, the external sector demands through WTO that there is strict adherence to the trade treaties and commitment to free trade. This may lead the government to the dilemma. If a country objectively has a commitment to free trade, she also expects a trade with a country with a commitment to free trade. A commitment to a free trade may be an unpopular policy initiative leading to the visible protest and perceived loss of employment opportunities. A country is open to foreign trade due to the various advantages of international trade. Most importantly, it is able to fulfil the demand of its household and firm sector.

The empirical study results indicate that massive capital accumulation of the export sector brought down Singapore's unemployment rate in the four decades before open trade policy was established. (Kee and Hoon, 2004). Strong possible explanation for the strong European agricultural protection or the EU trade policy is home bias (Eriksson 2006). War on Want is an international alliance of NGOs concerned with issues of justice and with historical links to the labour movement. They are at the forefront of the trade justice movement claiming that free trade threatens the employment around the world.

The main areas of employment in services associated with exports were similar to those areas most prominent of employment in all service activities in Indonesia. The huge contribution of trade to employment is presumably a reflection of the labour intensive character of the trade activities associated with exports: exports of primary commodities for example, are likely to engage a large number of traders. (Manning & Aswicahyono, 2012). For the exporting country when the foreign demand for its product increases, it needs to undertake the production activities, which implies that the employment opportunities in the exporting nation are likely to increase. Assuming all other factors like international competitiveness of the importing nation remains equal, its import increases. This may lead to a fall in the domestic demand for almost substitute domestic good or the domestic alternative for the foreign product, which is not competitive in international trade. This might result in

the decrease in production and thereby decrease in the employment opportunities in the importing countries. This may further result in trade barriers by the importing countries.

The economic growth and development is observed to commensurate with sector shifts in an economy. The primary sector loses its important share in the process of economic growth. As the country develops economically, a larger share of GDP is contributed by the secondary and tertiary sector. The importance of the primary sector declines in the generation of national income. The firm and, the consumer demand for foreign goods are purely rational choices, motivated by the maximization of budget. The government objectives are also to ensure the growth and development, structural unemployment is essential to tackle. For a developing economy there are many obstacles, the problem of unemployment and the creation of structural employment opportunities is one of the most important.

There have been several studies about the role of foreign direct investment FDI in the economic development, a topic beyond the scope of this paper. An open economy with favourable corporate governance is expected to receive higher FDI and we expected it to be positively correlated to the number of complaints. We provide a chain of reasoning about the way in which international property rights or soaring foreign direct investment could lead to complaints of a WTO member country in diagram one. Please recall that the theory of Pareto optimality states that free trade is the optimum way of maximizing the welfare of the trading countries. The distortion in terms of any tariff, any non-tariff or voluntary trade restriction would distort the mechanism leading to sub optimum or disruptive trade. How this disruptive trade may arise based on other than objective complaint behaviour is illustrated in the reasoning in diagrams one and two. In the era of globalization and trade liberalization the protectionism is certainly not a policy that commensurate with WTO membership. The WTO stands for multilateral treaties and for lack of barriers.

**European bureaucracy: Should the EU Sell Bent Cucumbers?**

DPA For years, EU critics only had to mention the "Bent cucumber rule" whenever they wanted to mock perceived European over-regulation. Now, the EU's agriculture minister has suggested scrapping a number of rules to ease the rising price of food. Regulation first-class unbent European cucumbers.



According to European Commission Regulation No. 1277/88, if a cucumber bends more than 10 millimetres per 10 centimetres (0.4 inches per 4 inches) in length, it cannot be categorized as "class one" and may therefore only be sold as a second-rate cucumber. But who wants to buy one of those? Most second-rate cucumbers -- at least according to conventional wisdom -- never make it to market.

*Box 3: Bent Cucumbers: Isn't second rating odd shaped cucumbers a way of frustrating competition, protecting the home based industries as in the case of the textile crises of box 2?*

The international labour organization studies by Janse en Salazar-Xirinachs mentions that " .. Perceptions of the employment impact of trade are probably one of the main explanations for the current stalling in multilateral trade negotiations...." This is not necessarily explicit and trade negotiators do not tend to put employment concerns forward as a reason for inflexibility in negotiation positions. This even though there is consensus among the economists about the role of an open economy in economic growth. The trade liberalization, the export promotion rather than import substitution did prove to be a key to economic success. To attain the Pareto optimum based on comparative advantages in the international trade implies absence of tariffs or any other barriers, leading to efficient use of

resources and development of trade specializations which leads to welfare gains of the trading countries. All Pareto-efficient allocations are thus characterized by production efficiency (Keen and Kotsoginannis 2012).

### **Research question and methodology**

This study examines the possible causality which might exist between the complaints lodged by the member countries of world trade organization henceforth WTO and indicators of economic structure at macro cross-country level with a dataset of 28 countries. In our research we found an actual trend involving home bias. We repeat former analysis and in our modelling efforts we take the number of complaints at the WTO as our dependant variable.

There are clear cases of complaining at the World Trade Organization in which home bias is plausibly the reason for complaining, rather than objective criteria of the rules of trade agreements as mentioned in this paper. Next to home bias in individual cases induced home bias leading to complaining at World Trade Organization (WTO) might also be a trend.

We formulated the following research question:

"Which factors are responsible for the complaining behaviour of Eurasian WTO member countries, if not objective factors, which are the other factors which could explain the complaining behaviour of Eurasian WTO member countries?"

Using correlation and stepwise regression analysis a dataset on 28 complaining countries is analysed in earlier research. The number of complaints at the WTO was the dependent variable in exploratory modelling. Independent variables are various variables on economic structure. Structural Unemployment (SUN), Agricultural Import Share (AIS), Current Account Balance (CAB) , International Property Rights (IPR) and Foreign Direct Investment (FDI) turned out to be significantly related to the number of complaints (Samplonius & Waalkens, 2013) in this subset of 28 countries basically from all over the world. There are strong indicators that complaining at the WTO is at least partly induced by other than objective factors, we refer to the cases in boxes 2 and 3 in this article. These factors other than objective factors are in these cases induced home bias, leading to disruptive trade.

We investigate the correlation between level of gross domestic product per capita and various other indicators of economic structure and -development and its linkages to the number of complaints. The level of development is closely associated with the employment structure in the economic sectors, share of sectors in export and import and other factors like FDI, CAB, SUN AIS and IPR. This includes an examination of the number of complaints and the employment structure of the WTO member countries. We have to bear in mind the level of aggregation of the data. The association between the trade barrier complaints and economic variables can be estimated by carrying out correlation and regression analysis. Furthermore presented cases are part of the analysis. We draw the regression table, after we enter variables on economic structure in a regression equation using step-wise regression to estimate how much variation we can explain using our Eurasian data. The significant correlation between the number of complaints as a dependent variable and a number other independent variables CAB, SUN, AIS, IPR and FDI is estimated by regressing the cross –section of economic structure indicators on a set of regressors of two types: a measure of economic structure and control variables. T testing has been used to asses if these variables differ significantly between the subset of 28 countries and the Eurasian subset.

### **Exploring the Eurasian data**

We explored the data of our correlation table. Each variable was entered into the regression equation stepwise. In this way we tested the outcome of the explorative modelling model of the research on 28 countries. As we applied the statistical approach mentioned above, we started with inspecting the correlation table containing various economic

indicators. We correlated the number of complaints to these economic indicators that relate to the structure of the economy in the subset of Eurasia.

Significant correlations from the correlation table are:

- The percentage of fuel and mining share and number of complaints against or the frequency of respondents is 0.40 at 0,05 level,
- The percentage of agricultural import share and % of agriculture X share correlated at 0,697 at 0,01%,
- The agricultural imports of the Eurasian countries go along with the agricultural export share. This could be also the result due to the agricultural barter trade which is not uncommon in the international trade,
- The percentage of Agricultural Import Share and the percentage of Manufacturing Share in Export at 0,577 at 0,01 level,
- The Agriculture Import Share AIS with manufacturing share in exports. The Eurasian countries have to allocate the scarce resources in the manufacturing sector and higher the export share higher the need for agricultural imports,
- FDI and import share in the world trade is positively related 0,507 at 0,01 level,
- FDI and export share in the world trade is related 0,438 at 0,05 level.
- FDI is in T testing significantly different (much higher) for our 28 countries versus Eurasia.

The Bent Cucumber case is an example of a conflict on agricultural products, actually, a large share of complaints are related to agricultural products. Out of 366 GATT complaints, at least 159 have direct concern with the agricultural sector; 43%. In the case on Bent Cucumbers it is clear that the policy to rate differently shaped cucumbers second class is home biased; there is no relation between shape and quality of cucumbers. Supplemental data on the discussion can be derived from an analysis of our three short case studies of complaining at the WTO presented in this paper (See Boxes 1-3 and the next section on results).

The number of filed complaints correlated to the number of frequency of being respondents is very high: 0,986 at 0,01 level. Apparently the WTO trade platform works as an arena where when a country complains against a certain country is also likely to be complained against, though not necessarily by the same trading partner. High foreign investment means dependency and probably domestic pressure against highly competitive foreign industries, as we found in our earlier research on 28 countries, but FDI is much higher in Eurasia, yet we find no effect on the number of complaints, as in our subset of 28 countries. Then why the mechanism towards complaining as observed for 28 countries seems to be different for Eurasia?

### **Results case research, regression and T-testing**

We tried to fit regression models including the explanatory variables IPR, CAB SUN, AIS and FDI, but using stepwise regression but none of these variables was significant. We used a T test and found one variable to be significantly different: FDI. FDI is significantly much higher in Eurasia.

It turns out that the EU is the biggest complainer by far. Furthermore we asked which economic factors explain the variation in complaining. In our earlier analysis of 28 countries (EU not included) IPR, CAB, SUN AIS and FDI, using an odd data set with countries all over the world, including South American countries and India, turned out to be explanatory variables of the number of complaints. Unfortunately data on the Eurasian continent IPR, SUN, FDI and CAB are measured in most countries but lack in the case of the European Union as a whole. At the same time the EU act as a complainant like any other country in Eurasia. This has hampered our analysis for sure. We modelled the variables and entered

these in regression equations that turned out to have a bad fit. FDI for Eurasia proved to be significantly different than in the case of our 28 countries.

Concerning the textile sector (Box 2 on the Textile crises), sector structure in Eurasia has to adapt to a new reality. Low cost labour intensive production will continue to be pressured by low labour cost countries, despite quotas that cannot delay the inevitable if countries are truly committed to free trade and want to lessen trade barriers. Yet, perceptions of the employment impacts of trade liberalization are in many capitals an important determinant of the rank trade takes on the list of priorities for policy action because: "Trade liberalisation is unlikely to automatically create job miracles since successful integration into world markets tends to go hand in hand with the adoption of new technologies and productivity increases" (Marion Jansen & José Manuel Salazar-Xirinachs, 2012).

Returning to Foreign direct investment: FDI was in the eighties and nineties of the last century an affair of Europe – America – Japan (Baoumi & Lipworth, 1997), so naturally still prominent in Eurasian data because also now these two countries and the EU are still the most important investors in FDI in the world economy. Besides this, high FDI is in Eurasia in mineral and oil exploitation (in Georgia, having no oil itself, FDI is about oil *transportation*) and many greenfield investments are made, that don't directly affect the employment situation in Eurasian countries as FDI does in South American countries and for instance India. The population of Eurasia is largely in favour of FDI, our 28 countries are clearly much more divided on this subject and prove to have different economic structures. Integrating with regional partners has allowed a country like Kazakhstan to respond to the disruptions resulting from the 2008-09 global economic crisis not because of FDI but because the lack of it. "The crisis has thinned down the flow of FDIs (foreign direct investments) (...) Far from being a regression to Soviet-era stagnation and protectionism, integration with Kazakhstan's Eurasian neighbours will help expand the country's emerging global economic role." Whereby new FDI is sought and is most welcome (Aris, 2013).

FDI is related to the openness of the economy. The openness is related to the extent of export and import as shown. Higher the export and higher the import greater FDI can be expected in an average Eurasian country, though it can be observed that for export share the relation is somewhat weaker than for the import share for Eurasia. "Overall, FDI inflows to developing markets were only slightly down in 2012 year-on-year, while some markets, like Africa and labour-intensive economies in Eurasia like Vietnam, bucked the trend and saw increases. Meanwhile, investment into developed economies plummeted 32% to \$561bn – a level last seen almost 10 years ago." (Aris, 2013). A large share of forty-two per cent of Russians say foreign investments will help their economy, while about a minority share of one third (34%) say these investments will hurt the economy (Ray & Esipova, 2012). Opposite sounds can be heard in India: "Traders in Malgodown, the state's biggest wholesale market, have vehemently opposed the central government's decision to allow foreign direct investment (FDI) in the retail sector. Traders said the decision will affect local traders and small enterprises." (Jaiswal, 2012)

"The BRICS countries (Brazil, the Russian Federation, India, China and South Africa) continued to be the leading sources of FDI among emerging investor countries. Flows from these five economies rose from \$7bn in 2000 to \$145bn in 2012, still accounting for only about 10% of the world total. In the ranks of top investors, China moved up from the sixth to the third largest investor in 2012, after the United States and Japan," (Aris, 2013).

## Conclusion

The three presented cases show a picture of home bias being more than once a plausible explanation for EU trading policy. The case of Solar panels shows how complaining at the WTO is supposed to work: an objective anti-dumping complaint about a violation of a multilateral treaty. Though we could not capture home bias in our quantitative research, our



qualitative case research reveals a worrying tendency in the light of the ideal of free trade. FDI is an explanatory variable of complaining behaviour in earlier research on 28 countries but not in case of Eurasian nations, even if FDI is much higher in Eurasia. By now we can explain why, since FDI is not considered hostile in Eurasia, as it seems to be perceived in case of the 28 countries including South American countries and India.

Our correlation analysis brought several interesting insights, of maybe which the most interesting is that complaining nations almost automatically face complaints to themselves: complaining and responding are very strongly correlated. As to our regressions equations we need EU level data on IPR, CAB and FDI which have failed us to complete our analysis. For now the presented cases, the double sided role of FDI and the fact that complaining seems to induce complaining sheds light on our question if complaining is actually only induced by objective facts violating free trade or..? Complainers have to respond, responders complain, a never ending game in which we asked if motives for complaining are objective or related to other facts – Free trade in Eurasia for real? – or is home still where the heart is?

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